Postal Regulatory Commission
Submitted 4/9/2012 1:43:12 PM
Filing ID: 81895
Accepted 4/9/2012

**BEFORE THE**
**POSTAL REGULATORY COMMISSION**

| | | |
|---|---|---|
| **Institutional Cost Contribution Requirement for Competitive Products** | : | **DOCKET NO. RM2012-3** |

# INITIAL COMMENTS OF UNITED PARCEL SERVICE ON NOTICE OF PROPOSED RULEMAKING TO EVALUATE THE INSTITUTIONAL COST CONTRIBUTION REQUIREMENT FOR COMPETITIVE PRODUCTS
**(April 9, 2012)**

United Parcel Service, Inc. hereby responds to Commission Order No. 1108 (January 6, 2012) seeking comments on "how to ensure that the appropriate minimum contribution to the Postal Service's institutional costs is provided by competitive products." Order No. 1108 at 2.

Section 3633(b) of PAEA requires the Commission to review whether the Commission's initial determination of the appropriate share of institutional costs to be paid by competitive products "should be retained in its current form, modified, or eliminated." 39 U.S.C. § 3633(b). As discussed below, UPS believes that change is clearly needed.

## IMPORTANCE OF PROCEEDING

While UPS is a significant competitor of the Postal Service, UPS has also become a major vendor of the Postal Service as well as a large postal customer. As such, UPS not only supports, but has a vested interest in, a healthy and viable Postal

Service. UPS' comments and suggestions seek to identify and address trends and resulting issues that affect UPS, the rest of the postal community, as well as potentially the U.S. taxpayer.

This proceeding is important for the following reasons:

1. Competitive Safeguard – The appropriate share requirement is a major safeguard established by PAEA to ensure fair competition with the private package delivery industry. 39 U.S.C. § 3633(a). As the House Report states, "[U]nlike the unconstrained pricing flexibility recommended by the President's Commission for competitive products, the bill imposes limited but important controls to protect the public interest from unfair competition." H. R. Rep. No. 109-66, Part 1 (April 28, 2005) at 43. See also Order No. 1108 at 2 ("[E]stablishing a markup that is too low could give the Postal Service an artificial competitive advantage.")

2. Institutional Costs Are Increasing Compared to Attributable Costs – Without question, the Postal Service has engaged in aggressive cost reductions. While total costs have been reduced, attributable costs may be eliminated at a proportionally faster rate than institutional costs as the Postal Service reconfigures its network and services. When institutional costs increase relative to attributable costs, it is even more important that those institutional costs are allocated in an appropriate manner.

3. The Next Appropriate Share Review Under Section 3633(b) of PAEA Is Not Until 2017 – PAEA requires the Commission to review the appropriate share every five years. 39 U.S.C. § 3633(b). The next review under the five-year cycle is not scheduled to begin until 2017. The rapidity of technological and consumer behavioral changes in the postal sector underscores the importance of the Commission's careful

review of the appropriate share requirement and its reconsideration of the initial approach. UPS urges the Commission to revise the methodology; it is relevant to the fiscal health of the Postal Service.[1]

4. The Current Approach Is Not Compatible With the Postal Service's Changing Business Model – By FY2020, First-Class Mail is expected to contribute at least $5 billion less per year than it did in FY2011.[2] As discussed below, the reliance on First-Class Mail volumes to pay the lion's share of institutional costs is unsustainable for the future.

## THE CURRENT POSTAL BUSINESS MODEL IS BROKEN

Under the current appropriate share approach, competitive products have contributed a static percentage (5.5%) of total institutional costs while market-dominant

---

1. It should be noted that the Commission recognizes in Order No. 1276, which granted a one-month delay in the comment period, the potential for a mid-five-year cycle review:

> "The PAEA . . . specifically authorizes the Commission to revise its competitive product rules from 'time to time.' 39 U.S.C. 3633(a). Thus, the Commission is not limited to reviewing competitive products' contribution at 5 year intervals.
>
> * * *
>
> "If such relevant circumstances materialize, interested parties may petition the Commission to initiate such a rulemaking, or the Commission may act independently to initiate another rulemaking."

Order No. 1276 (March 7, 2012) at 4.

2. First-Class Mail volume is expected to decline by nearly 35 billion pieces by FY2020. Compare Appendix B, Postal Service's FY2020 First-Class Mail volume forecast (39 billion pieces), to FY2011 First-Class Mail volume (nearly 74 billion pieces) in FY2011 Public Cost & Revenue Analysis Report, Docket No. ACR2011, USPS-FY11-1 (December 29, 2011). At First-Class Mail's current contribution per piece (21.7 cents, FY2011 Public CRA Report), First-Class Mail will contribute approximately $7.5 billion less each year beginning in FY2020 than it did in FY2011.

products are asked to pay the remaining share of institutional costs (in FY2011, about 94%), regardless of competitive products' proportionate use of the Postal Service's integrated infrastructure.[3] The postal business model has long relied on First-Class Mail to pay the lion's share of institutional costs. However, the precipitous decline in First-Class Mail volumes, potentially exacerbated by a possible 50-cent stamp price, makes it unlikely that market-dominant products as a whole will shoulder their current institutional cost burden.

Because First-Class Mail generates more than half of the Postal Service's actual overhead cost contribution, its volume decline has serious repercussions for the entire

3. Despite a widespread assumption to the contrary, competitive revenue in excess of the mandated "appropriate share" and the imputed tax does not automatically go toward institutional costs. To illustrate: in FY2011, competitive products' revenue in excess of attributable costs was $2.317 billion. Docket No. ACR2011, FY2011 Postal Service Annual Compliance Report (December 29, 2011) at 64. Dividing that number by total Postal Service institutional costs ($29.554 billion) has led to the conclusion that competitive products contributed 7.84% of institutional costs in FY2011. Id. (In its Motion to extend the comment period in this docket, the Parcel Shippers Association also stated, "Since enactment of the PAEA, the [competitive] coverage has increased slightly." Motion of the Parcel Shippers Association to Extend the Period for Preparing Initial and Revised Comments, February 24, 2012, at 4.) But the Competitive Products Fund Income Statement for FY2011 shows that only $1.625 billion (the mandated 5.5% of total institutional costs) plus the imputed tax payment of $242 million, or a total of $1.867 billion -- not the full $2.317 billion -- was transferred to the Postal Service Fund. See Consolidated Annual Summaries of Competitive Product Financials, FY2008-FY2011, attached hereto as Appendix A. The remaining $449 million remains in the Competitive Products Fund. Compare Competitive Products Fund balance in Treasury's Monthly Statement of the Public Debt (December 31, 2011) at 10 ($607 million) with same statement (January 31, 2012) at 10 ($1.057 billion); see Commission's FY2011 Annual Compliance Determination Report (March 28, 2012) at 165.

postal system.[4] The only other major market-dominant product that makes a significant contribution to institutional costs is Standard Mail. But even if Standard Mail volume grows, the Postal Service would have to add three new pieces of Standard Mail for every First-Class Mail piece that is lost.[5] See Appendix B.

At the same time, due in part to the current methodology, competitive products earned their largest after-tax profit in FY2011, adding nearly $450 million to the Competitive Products Fund -- the most since PAEA was adopted -- and bringing its balance to over $1 billion.[6] The competitive product category's share of the Postal Service's revenue is growing at a substantial rate, from 11.2% of the Postal Service's revenue in FY2008 to 13.7% in FY2011, to more than 17% for FY2012 (projected), and its share of total attributable costs has grown to over 16%,[7] while its appropriate share

4. "In addition to widespread concerns about total volume declines in the postal community, there have also been major concerns that a disproportionate amount of the decline would take place in First-Class Mail, which has a higher current profit per piece than any other major category of mail." Implications of Declining Mail Volumes for the Financial Sustainability of the Postal Service, Robert H. Cohen and Charles C. McBride, U.S. Postal Service Office of Inspector General, Risk Analysis Research Center, Report No. RARC-WP-10-006 (September 29, 2010) at 30.

5. See FY2011 Annual Compliance Determination Report at 24.

6. See Appendix A.

7. For FY2008 and FY2011 revenue shares, see Appendix A; for projected FY2012 revenue share, see Docket No. CP2012-2, Contribution and Cost Coverage Analyses appended to Postal Service Notice (November 22, 2011), forecasted FY2012 competitive products revenue (over $11 billion) divided by forecasted total revenue ($64 billion) from FY2012 Postal Service Integrated Financial Plan (November 23, 2011) at 1; for attributable cost share, see FY2011 Public CRA Report, Total Competitive Mail and Services attributable costs ($6.680 billion) divided by Total All Mail and Services attributable costs ($41.252 billion).

allocation of institutional cost remains static at 5.5%.[8] In other words, competitive products now account for a significantly larger portion of usage of the postal network. As the Public Representative recently recognized, "Competitive products [are] becoming a more important part of the Postal Service's revenue stream." Public Representative Comments on PSA Motion to Extend Initial and Reply Comment Period (February 29, 2012) at 1. The balance in the Competitive Products Fund is expected to continue to grow, with the volume and contribution of market-dominant products likely to further decline. Yet, competitive products still contribute the same fixed percent of institutional costs while market-dominant products have not achieved their 94% contribution allocation since the implementation of PAEA.[9]

THE COMMISSION'S REVIEW
OF THE APPROPRIATE SHARE REQUIREMENT

In the current docket, the Commission may choose to retain the appropriate share requirement in its current form, to modify it, or to eliminate it. 39 U.S.C. § 3633(b). As indicated, UPS recommends against continuation of the fixed contribution approach.

---

8. These increases contrast with PSA's assertion, in its Motion to extend the comment period in this docket, that domestic competitive product volume has remained "relatively stable" since PAEA was implemented. PSA Motion at 5. In addition to the increases in revenue and attributable cost shares, competitive product volumes are predicted to increase by over 60% in FY2012 due to the transfer of over 1 billion packages from the market-dominant group to the competitive product group. See Docket No. CP2012-2, Postal Service Contribution and Cost Coverage Analyses, projected FY2012 competitive products volumes. The Postal Service asserts in its Answer to PSA's Motion that competitive products' share of contribution has grown over the past five years to 7.84%. Answer of the Postal Service to PSA Motion (March 2, 2012) at 3. We address this assertion in footnote 3, supra.

9. See FY2011 Annual Compliance Determination Report at 21 (Postal Service has operated at a loss each fiscal year under PAEA).

1. <u>Should the Current Methodology Be Retained in Its Current Form?</u>

The rapid and substantial decline in First-Class Mail volume and revenue, the growth in competitive revenue from increased e-commerce goods delivery and the substantial, ongoing transfers of formerly market-dominant products to the competitive category all combine to undercut the current approach. Under that approach, competitive products need not make any additional contribution to institutional costs, even though additional contribution from competitive products could help ease the Postal Service's financial issues.

In particular, under the current fixed approach, revenues from new and transferred competitive products need not make any contribution to institutional costs (other than perhaps a small increase in the imputed tax payment if they generate additional profit). As long as revenues from previously-existing competitive products cover the 5.5% appropriate share payment, additions to the competitive products group, whether from transfers or new products, actually ***do not*** make any contribution to institutional costs: all revenues earned on those products, after payment of their attributable costs and any resulting increase in the imputed tax, are retained in the Competitive Products Fund.

Substantial additional volumes and revenues have been added to the competitive product grouping as the result of product transfers from the market-dominant product grouping. Although some of the market-dominant transferred products' revenues were below attributable cost, some were not, and, due to the transfer of a large volume to competitive products, that category should be better able to make an increased contribution. The transfers alone necessitate an increase in the contribution from competitive products.[10]

The current approach also fosters substantial regulatory lag: there may be no change in competitive products' required contribution to reflect any of these (or other) changes to the competitive products grouping until the next appropriate share review.

In initially setting the appropriate share, "[t]he Commission gave considerable weight to the historical contribution made by items categorized as competitive products by the PAEA." Order No. 1108 at 2. At that time, competitive products represented a significantly smaller percentage of the Postal Service's total revenue. Unfortunately, under a fixed contribution approach, competitive products are not required to contribute more despite increased competitive revenues.[11]

Setting competitive products' contribution level at a static, years old performance level does not reflect the increased relative benefit these products derive from their use of the postal network and other common resources. The current contribution level is out

---

10. See Docket No. RM2007-1, Order No. 26 (August 15, 2007) at ¶ 3061 ("The Commission anticipates that [the] need [to revise the appropriate share] may arise for any number of reasons, *e.g.*, additions or deletions to the competitive product lists and market conditions"); Docket No. MC2009-19, Order No. 391 (January 13, 2010) at 29 ("The Commission agrees with UPS that the cumulative impact of adding products to the Competitive Product List must be evaluated.")

11. When it adopted the current requirement, the Commission took a conservative approach: during the two years it used to arrive at the 5.5% requirement, competitive products' contributions were historically low. Over the prior 15 years, competitive products' historical contributions ranged between approximately 6.6% and 9.8%. See Docket No. RM2007-1, Comments of United Parcel Service in Response to Order Proposing Regulations to Establish a System of Ratemaking (September 24, 2007) at 4-5. As the Commission has recognized, "[s]ince it is no longer subject to the pricing constraints of the PRA, the Postal Service should perform *at least* as well as it has historically." Order No. 26 at ¶ 3060 (emphasis added).

of step with competitive products' share of revenue and their share of attributable costs, metrics that are often used by businesses to allocate overhead costs.

A key reason for using the low, fixed contribution level was likely to ease the Postal Service's transition under PAEA's first few years by ensuring that competitive products could easily meet the appropriate share requirement. Order No. 26 at ¶ 3058 ("In attempting to quantify an appropriate contribution, the Commission is mindful of the risks of setting it too high, particularly at the outset . . . ."). While that goal may have arguably had merit when PAEA was adopted after decades of break-even regulation, it is far less relevant now that PAEA has been in effect for approximately five years and competitive products have demonstrated the ability to generate greater contribution under the new statutory framework. With over $1 billion (and counting) in the Competitive Products Fund, the Postal Service now has a substantial safety net: should competitive product revenues fall short of paying an increased contribution level in any of the next five years, these retained earnings may be used to make up for the competitive contribution shortfall.

2. Should the Current Methodology Be Modified?

UPS recommends that the Commission adopt an approach that self-corrects for changes in the relative size of the two categories of products that contribute to institutional costs.

There are a number of contribution approaches that would ensure competitive products bear institutional costs more proportional to their use of the Postal Service's integrated infrastructure and that would also require the Postal Service to use more competitive product revenue to help make up for the decreasing contributions from market-dominant products. A variable, self-adjusting mechanism that accounts for dynamic changes in the market, such as changes in mail mix, would accomplish these goals while also reducing the administrative burden the Commission would otherwise face.

For example, the appropriate share could be based on a cost or burden approach, such as equal cost coverages (a similar institutional cost allocation approach was proposed during the development of PAEA),[12] or on a market-based approach, such as percentage share of revenue.[13]

## PHASING IN A NEW METHODOLOGY

A change in methodology may necessitate a transition period. The Commission could phase in the new requirement over the five-year period prior to its next review of the appropriate share determination.

We realize that there are many "moving parts" within the Postal Service product lines, and any changes required through adopting a new method may require a phase-in period in order to smooth the impact. Any such change and its implementation methodology would be subject to review during the prescribed five-year PRC review cycle. Under any approach, if competitive products do not generate enough revenue to cover the new requirement in a given year, the $1 billion of retained earnings now in the Competitive Products Fund could be used first to make up the deficiency.

---

12. Postal Modernization Act of 1999, H.R. 22, 106th Cong. § 201 (1999) (proposed change to 39 U.S.C. § 3744(a)(1)).

13. Docket No. RM2008-5, Order No. 151 (December 18, 2008) at 6; see Horngren, Charles T., et al., Cost Accounting: A Managerial Emphasis, 13th Ed. (2009) at 575.

## CONCLUSION

The business model long applicable to the Postal Service is broken, which jeopardizes the payment of institutional costs under the current system. In sum, the Commission should modify its current methodology so as to yield a contribution level that (1) has a basis in competitive products' use of the Postal Service's network and (2) adjusts to market realities as circumstances change. If necessary, the Commission should use a transitional approach to move toward the desired goal without exacerbating the Postal Service's dire financial condition. A key fact in this proceeding is that market-dominant mail has been unable to make its 94% contribution allocation. Improving the appropriate share methodology could help address this problem.

Respectfully submitted,

John E. McKeever
Laura B. Mitchell
Attorneys for United Parcel Service

McKeever & Mitchell
335 Wyndmoor Lane
Huntingdon Valley, PA 19006
(215) 947-5765

**APPENDIX A**

## CONSOLIDATED ANNUAL SUMMARIES OF COMPETITIVE PRODUCT FINANCIALS, FY2008-FY2011 (in millions)

| | | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|
| (a) | Competitive Product Revenue | $8,382 | $8,133 | $8,678 | $8,996 |
| (b) | Competitive % of Total Postal Service Revenue | 11.2% | 11.9% | 12.9% | 13.7% |
| | | | | | |
| (c) | Cost Attributed to All Competitive Products | $6,600 | $6,175 | $6,257 | $6,680 |
| | | | | | |
| (d) | Total Institutional Costs | $32,136 | $28,905 | $34,006 | $29,554 |
| (e) | 5.5% of Total Institutional Costs | $1,768 | $1,590 | $1,870 | $1,625 |
| | | | | | |
| (f) | Net Income (a)-(c)-(e) | $14 | $368 | $551 | $691 |
| (g) | Imputed Income Tax (~35%)x(f) | $5 | $129 | $193 | $242 |
| | | | | | |
| (h) | Revenue Minus Attributable Costs (a)-(c) (Reported "Contribution") | $1,782 | $1,958 | $2,421 | $2,317 |
| (i) | Actual Contribution (e)+(g), which also equals (h)-(j) | $1,773 | $1,719 | $2,063 | $1,867 |
| | | | | | |
| (j) | Competitive Product Retained Earnings (h)-(i) | $9 | $239 | $358 | $449 |
| (k) | Cumulative Competitive Product Fund (CPF) Balance | $9 | $249 | $606 | $1,057 |

Sources:

Rows (a), (c), (e), (f), (g), and (j) – FY2009-FY2011 Competitive Products Income Statements, filed with Annual Compliance Reports as Table 1 (PRC Form CP-01) of Library References USPS-FY09-39 (December 29, 2009), USPS-FY10-39 (December 29, 2010), and USPS-FY11-39 (December 29, 2011).

Row (b) – Row (a) divided by Total Revenue from FY2008-FY2011 PRC Annual Compliance Determination Reports (FY2008 at 12, FY2009 at 30, FY2010 at 31, and FY2011 at 32).

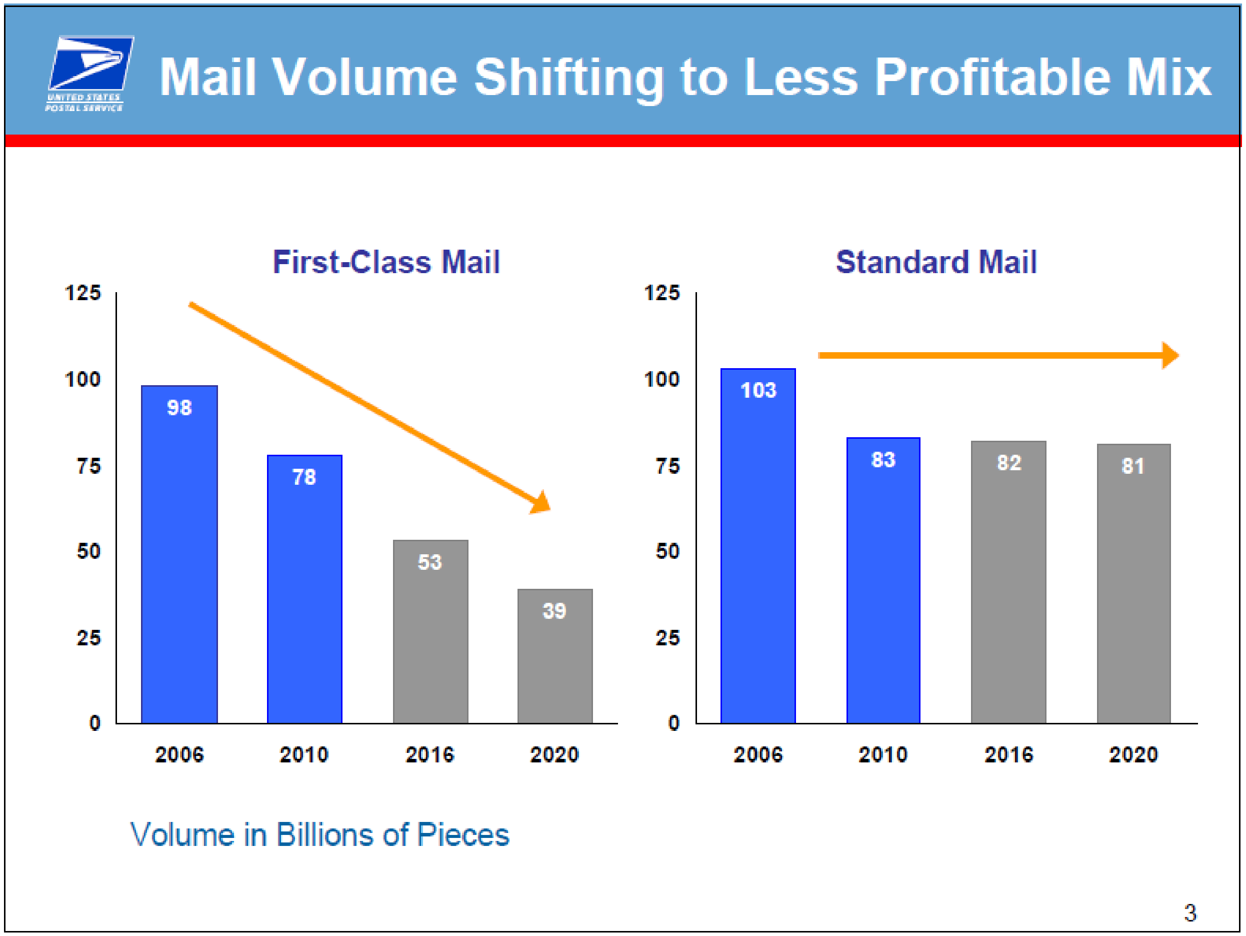
Row (d) – FY2008-FY2011 PRC Annual Compliance Determination Reports (FY2008 at 12, FY2009 at 30, FY2010 at 31, and FY2011 at 32).

Row (h) – see also FY2009 PRC Annual Compliance Determination Report at 116; FY2010 Postal Service Annual Compliance Report at 67; and FY2011 Postal Service Annual Compliance Report at 64.

Row (k) – U.S. Department of the Treasury's Monthly Statements of the Public Debt of the United States, December 31, 2009 at 10, January 31, 2010 at 10, January 31, 2011 at 10, and January 31, 2012 at 10; see also PRC FY2011 Annual Compliance Determination Report at 165.

Slight discrepancies due to rounding.

**APPENDIX B**




USPS Financial Future: Responsibly Realigning Our Network (February, 2012) at 3, located at: http://about.usps.com/news/facility-studies/assets/pdf/Mailers_Webinar_Feb_2012.pdf